

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:LI:POSTF-120740-02
DRMirabito

date: May 29, 2002

to: [REDACTED] Manager, LMSB
[REDACTED], Team Coordinator

from: Jody Tancer, Associate Area Counsel LMSB
(Financial Services:Long Island)

subject: [REDACTED] Inc. (EIN [REDACTED])
Acquisition of [REDACTED], Inc. and
Subsidiaries

You requested advice regarding whether [REDACTED]
[REDACTED], Inc. ([REDACTED] or taxpayer) is entitled to a carryover
loss claimed in the fiscal year ended March 31, [REDACTED] as a result
of its acquisition of [REDACTED], Inc. and
subsidiaries ([REDACTED] or [REDACTED]). This memorandum
should not be cited as precedent.

ISSUE

Whether the taxpayer is entitled to the full amount of a
claimed carryover net operating loss, resulting from its
acquisition of the [REDACTED], under the overlap rules of
Internal Revenue Code § 382, Treas. Reg. § 1.1502-15(g), and
Treas. Reg. § 1.1502-21(g)?

CONCLUSION

The overlap rules apply here and [REDACTED] is entitled to compute the
NOL under § 382 without applying the SRLY rules.

FACTS

The facts, as we understand them, are as follows:

On [REDACTED], [REDACTED] acquired [REDACTED]% of the stock of the [REDACTED]

██████████ for \$██████████ cash.¹ Prior to this acquisition, ██████████ was the common parent of an affiliated group and filed a consolidated calendar year income tax return. ██████████ was not related to any member of the ██████████ prior to this acquisition.

On its consolidated corporate income tax return for the fiscal year ended March 31, ██████████, the taxpayer reported total taxable income of \$██████████; \$██████████ of the reported taxable income was attributable to the ██████████. The ██████████ also reported net operating loss carryovers of approximately \$██████████; \$██████████ (\$██████████ per the taxpayer) of these carryovers (the subject carryovers) qualify under the SRLY/\$ 382 overlap rule of Treas. Reg. § 1.1502-21(g). ██████████ claims it is entitled to a NOL deduction in the amount of \$██████████, claiming that the \$ 382 limitation should be applied against its total taxable income of \$██████████.

In a letter dated ██████████ from its accountant KPMG, the taxpayer takes the position that the subject carryovers are subject only to a \$ 382 limitation and not the SRLY limitation. Specifically, the taxpayer argues that: (1) the acquisition of the ██████████ gave rise to a SRLY event; (2) the acquisition gave rise to a \$ 382 event; (3) the SRLY event and the \$ 382 event occurred simultaneously, and thus within 6 months of each other; (4) the SRLY subgroup with respect to the subject carryovers and the \$ 382 subgroup with respect to the subject carryovers are co-extensive as each includes all members of the ██████████; and (5) the overlap rule should eliminate the SRLY limitation and the subject carryovers should only be subject to a \$ 382 limitation. The taxpayer cites Example 5 from Treas. Reg. § 1.1502-21(g)(5) in support of its position. Essentially, the taxpayer takes the position that \$ 382 permits a fixed amount of income to be used each year to absorb a loss, regardless of the actual income contribution of the loss corporation (or group).

The audit team takes the position that the allowable carryover from the ██████████ should only be \$██████████ (the ██████████ subgroup income reported on ██████████'s consolidated Form 1120) since ██████████ was neither a member of the ██████████ loss group or the loss subgroup. Thus, the actual income generated by the ██████████ members determines the amount of \$ 382 limitation available to the new consolidated group and the overlap rule should only apply

1 ██████████

within the [REDACTED] subgroup.

We understand that the audit team does not dispute that the provisions of § 382 supercede the consolidated return regulations where they overlap and that here the overlap requirements are met. Further, we understand that the audit team agrees that the acquisition of the [REDACTED] constituted an ownership change under § 382(g) giving rise to the imposition of a § 382 limitation with respect to the subject carryovers. We also understand that the audit team is not considering an argument that the subject carryover should be limited under Internal Revenue Code § 269.

ANALYSIS

In T.D. 8823, the Service published final regulations, effective June 25, 1999, on certain deductions and losses of members who join a consolidated group. I.R.B. 1999-29, 34 (July 19, 1999). In summary, the regulations provide rules for computing the limitation with respect to separate return limitation year (SRLY) losses, and the carryover of losses to consolidated and separate return years. Further, the regulations eliminate the application of the SRLY rules in certain circumstances if the rules of § 382 also apply. See Treas. Reg. §§ 1.1502-15 and 1.1502-21. In the instant case, we think the circumstances here bring the taxpayer's acquisition of the [REDACTED] under the § 382 rules rather than the SRLY rules.

The audit team's position was supported by the proposed regulations published in 1991 and the temporary SRLY regulations published on June 27, 1996 pertaining to the carryover of losses to consolidated return years and separate return years and rules regarding the application of § 382. The 1991 proposed regulations generally retained the approach of the earlier SRLY regulations in limiting a consolidated group's use of attributes arising in or attributable to a SRLY and introduced the concept of subgrouping. Subgrouping was added since determining the carryover limitation separately for each member of a consolidated group and under a year-by-year approach was inconsistent with the single entity approach to the use of losses under the consolidated return regulations.

Prior to publishing T.D. 8823, the Service received comments arguing for and against eliminating the SRLY rules. Arguments favoring elimination of the SRLY rules included: (1) § 382 provided sufficient protection against loss trafficking transactions; (2) the § 382 and SRLY rules overlapped to a large extent and requiring taxpayers to analyze transactions under both

sets of rules was time consuming and resulted in little additional revenue; (3) the SRLY rules imposed a meaningful limitation only where, for regulatory or other reasons, loss corporations could not be combined with other profitable businesses; and (4) the SRLY rules were inconsistent with treating the consolidated group as a single entity. Arguments favoring retention of the SRLY rules included: (1) § 382 does not always apply when SRLY does and eliminating the SRLY rules would increase loss trafficking through carryback transaction to which § 382 does not apply; (2) § 382 is based on the idea that the rate of loss utilization following a change in ownership should be based on the expected income generated if all assets were converted to tax-exempt debt instruments. Thus, § 382 permitted a fixed amount of income to be used each year to absorb a loss, regardless of the actual income contribution of the loss corporation; and (3) under § 382 and in the absence of the SRLY rules, the available loss could be used against any member's income. In contrast, SRLY limited the loss usage to the actual income generation by the SRLY member, assuring that the loss attributes arising outside of the consolidated group are not generally available to the other group members.

As stated in T.D. 8823, the Service believes that limitations on the extent to which a consolidated group can use attributes arising in a separate return limitation year remain necessary. However, the Service is concerned about the complexity in applying the SRLY rules, especially where both the SRLY and § 382 rules apply. The T.D. recognizes that the SRLY limitation is based on the member's or subgroup's actual contribution to consolidated taxable income while the § 382 limitation is based on the expected income generation of the member or subgroup determined with reference to its value on the change date. Generally, the single entity approach taken in § 382 reflects the ability of corporations filing consolidated returns to use all member losses as well as the principle that the tax laws should operate in a neutral manner with respect to changes in ownership. Thus, under this neutrality principle, losses arising while two or more corporations are members of one group and that are therefore available to used among the members should remain available following an ownership change.

The Service believes that on balance the simultaneous or proximate imposition of a § 382 limitation reasonably approximates a corresponding SRLY limitation. Thus, the final regulations eliminate the SRLY limitation in circumstances in which its application overlaps with that of § 382. See Treas. Reg. § 1.1502-15(g) Overlap with section 382, stating, "(1) General rule. The limitations provided in § 1.1502-21(c) [Built-in losses of subgroups] ... do not apply to ... loss carryovers

... when the application of paragraph (a) of this section results in an overlap with the application of section 382." Moreover, Treas. Reg. § 1.1502-21(g), Overlap with section 382, also provides a general rule that the limitation provided in paragraph (c) of this regulation [limitations on NOL carryovers from separate return limitation years] does not apply to NOL carryovers when the application of paragraph (c) results in an overlap with the application of § 382.

In addition, the final regulations provide special overlap rules for subgroups. Generally, the overlap rules apply to the subgroup as a whole and not separately to the individual members of the subgroup. However, the overlap rules does not apply unless the SRLY subgroup is coextensive with the § 382 loss subgroup. As noted above, the audit team agrees that the overlap requirements are met here.

In addition, we think the example given in T.D. 8823 applicable here. The example states:

[A]ssume that the S consolidated group (composed entirely of S and T) has a \$200 consolidated NOL, of which \$100 is attributable to S and \$100 is attributable to T. If the M group acquires the S group, S and T compose both a SRLY subgroup as well as a § 382 loss subgroup. Because the subgroups are coextensive, the overlap rules applies to eliminate the application of SRLY in the M group for the \$200 consolidated NOL.

This example is substantially similar to the example cited by the taxpayer in support of its position as noted above.

In conclusion, based on T.D. 8823 and its final regulations, specifically Treas. Reg. §§ 1.1502-15(g) and 1.1502-21(g), we think [REDACTED] is entitled to calculate the NOL under the § 382 rules.

This opinion. is based upon the facts set forth herein. It might change if the facts are determined to be different. If the facts change, this opinion should not be relied upon. Please note that under routing procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this memorandum should be considered to be only preliminary.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact Ms. Mirabito at (516) 688-1709 for our views.

JODY TANCER
Associate Area Counsel
(Large and Mid-Size Business)

By: _____
DIANE R. MIRABITO
Attorney (LMSB)